

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:MSR:AOK:OKL:TL-N-5159-99
CGMcLoughlin

date: SEP 26 2000

to: Chief, Examination Division, Arkansas-Oklahoma District
Attn: Charles Musgrove

from: District Counsel, Arkansas-Oklahoma District, Oklahoma City

subject: Request for Advisory Opinion

Taxpayer: [REDACTED]

Taxable year: [REDACTED]

DISCLOSURE STATEMENT

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DISCUSSION

We are following up on our June 27, 2000, memorandum relating to a potential discharge of indebtedness issue for the subject taxpayer's [REDACTED] taxable year and a potential basis adjustment issue for the taxpayer's [REDACTED] taxable year. As you are aware, we submitted a copy of the memorandum to the National Office for review pursuant to CCDM (35)3(19)4(4). Based on that review, we recommend that the government pursue no audit adjustments associated with the taxpayer's acquisition of

[REDACTED] stock and the later liquidation of [REDACTED] and its assets. In the June 27, 2000, memorandum, we discussed the possibility of attacking the transaction as a discharge of indebtedness under I.R.C. § 108 or as a basis adjustment in the nature of a purchase price reduction. Following additional coordination, we are of the opinion that there is insufficient technical support for the government to pursue either theory.

The first problem is with the I.R.C. § 108 discharge of indebtedness theory. Since 1974, the government has taken the position that no discharge of indebtedness income occurs when a parent cancels its wholly-owned subsidiary's debt in an I.R.C. § 332(a) liquidation. Rev. Rul. 74-54, 1974-1 C.B. 76. Despite having been given authority to alter its position, through the issuance of regulations implementing I.R.C. § 108, the government has failed to take any actions overruling the regulation. (See, reservation in Treas. Reg. § 1.108-2(f)(3) of position on treatment of acquisition of indebtedness in nonrecognition transactions). In view of this, the government would not assert in litigation that the [REDACTED] stock acquisition/liquidation, a transaction indistinguishable from Rev. Rul. 74-54, generated discharge of indebtedness income.

Secondly, there is an interrelated problem with asserting a purchase price reduction under I.R.C. § 108(e)(5). Under that theory, we would have reduced the basis of assets acquired with the [REDACTED] debt. Those assets were sold by the taxpayer in [REDACTED] and a basis adjustment would have generated gains on the assets' disposition.

One of the basic requirements for an I.R.C. § 108(e)(5) purchase price reduction is a transaction which would otherwise generate discharge of indebtedness income. I.R.C. § 108(e)(5)(C). As mentioned above, we have no such discharge of indebtedness here. Rev. Rul. 74-54 once again intervenes and determines that no discharge of indebtedness occurred when [REDACTED] liquidated [REDACTED] in an I.R.C. § 332(a) transaction. As such, we lack the ability to adjust the basis of the [REDACTED] acquired assets using a purchase price reduction theory.

Please contact Glenn McLoughlin at (405) 297-4803 if you have any questions. We are closing our file.

/S/ MICHAEL J. O'BRIEN

MICHAEL J. O'BRIEN
District Counsel

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Internal Revenue Service

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Although we informally coordinated this matter with the National Office, the advisory is subject to the review procedures of CCDM (35)3(19)4(4). The CCDM procedures require us to transmit a copy of the memorandum to the National Office. The National Office has ten days from receipt of our memorandum to respond. The National Office may extend the review period if necessary. We will keep you informed of any delays.

DISCUSSION

We are responding to your [REDACTED] memorandum concerning the taxability of [REDACTED]'s (" [REDACTED] ") indirect acquisition of its own debt. You specifically requested our views on whether: (a) [REDACTED] recognized discharge of indebtedness income under I.R.C. § 108; or (b) [REDACTED] indirect acquisition of the debt would result in a reduction in the basis of assets acquired with the debt. These issues were the subject of a lengthy coordination process with the National Office, Chief Counsel. Based on that coordination, we are of the view that there is a basis for treating [REDACTED] indirect acquisition of the debt as generating discharge of indebtedness income under I.R.C. § 108. However, this position has significant litigation hazards. Alternatively, the government has grounds for reducing [REDACTED] basis in the assets acquired with the debt. This alternative position also has litigation hazards.

a. Facts

[REDACTED] purchased substantially all of the assets of [REDACTED] in [REDACTED]. [REDACTED] was then a subsidiary of [REDACTED] (" [REDACTED] "). [REDACTED] had been an unsuccessful foray into the [REDACTED] business by [REDACTED]. [REDACTED]'s principal businesses were the production and distribution of [REDACTED], contracting and an investment in a terminal business. [REDACTED] paid the following consideration for the assets: (a) \$ [REDACTED] cash; (b) a promissory note to [REDACTED] for \$ [REDACTED]; and (c) a convertible debenture to [REDACTED] with a face value of \$ [REDACTED] and a discounted principal value of \$ [REDACTED]. The convertible debenture had no interest payments due until maturity. Interest accruals were to be added to the principal of the debenture and received by [REDACTED] at maturity. As part of the transaction, [REDACTED] also agreed to provide [REDACTED] with a revolving credit line of up to \$ [REDACTED].

The [REDACTED] assets acquired from [REDACTED] consisted of [REDACTED] and [REDACTED] drilling rigs, [REDACTED] and [REDACTED] properties, land and equipment associated with the [REDACTED] work, cash and inventory. When calculating its basis for the assets acquired from [REDACTED], [REDACTED] appears to have included the \$ [REDACTED] cash consideration, the \$ [REDACTED] promissory note to [REDACTED] and the \$ [REDACTED] discounted principal value of the debenture issued to [REDACTED].

Between [REDACTED], and [REDACTED], an unrelated public company, acquired all the outstanding [REDACTED] stock. [REDACTED] acquired [REDACTED] to obtain its [REDACTED] business and its investment in the terminal business. [REDACTED] wanted to sell the other businesses and assets owned by [REDACTED]. This included [REDACTED] or its assets.

At the time of the [REDACTED] acquisition, [REDACTED]'s only assets were the [REDACTED] promissory note and the [REDACTED] convertible debenture issued and a \$[REDACTED] revolving credit loan note. [REDACTED] and [REDACTED] had negotiations concerning settling the outstanding debt. After some brief discussions, on [REDACTED], [REDACTED] offered to purchase all the outstanding [REDACTED] stock for \$[REDACTED]. [REDACTED] conditioned the offer on [REDACTED]'s representation that: (a) [REDACTED]'s only assets consisted of [REDACTED]' debt and the associated security interests in collateral; and (b) [REDACTED] had no debt. [REDACTED] accepted the offer and [REDACTED] acquired the [REDACTED] stock for \$[REDACTED] in [REDACTED].

At the time of the [REDACTED] acquisition, the outstanding balance on the [REDACTED] promissory was \$[REDACTED], the outstanding balance on the [REDACTED] convertible debenture was \$[REDACTED], including \$[REDACTED] in accrued but unpaid interest since [REDACTED], and the outstanding balance on the revolving credit note was \$[REDACTED]. After taking into account \$[REDACTED] in deemed payments to [REDACTED] under a [REDACTED] balancing agreement, the total outstanding balance due to [REDACTED] on all obligations was \$[REDACTED] as of [REDACTED].

There is no evidence that any specific forgiveness of the [REDACTED] obligations occurred after the [REDACTED] stock acquisition. However, [REDACTED] did not file a short period return for [REDACTED] and was never shown as a member of a consolidated return with [REDACTED]. Consequently, any interest accruals on the [REDACTED] debt occurring after [REDACTED], were not reported on any return. Similarly, [REDACTED] did not claim any deductions for the debt to [REDACTED] after the [REDACTED] stock purchase.

On [REDACTED], [REDACTED] entered into an agreement of liquidation and merger. Under the plan, [REDACTED] was to be merged into [REDACTED] and [REDACTED] was to be the surviving corporation in the statutory merger. The plan included no provisions specifically forgiving the [REDACTED] obligations to [REDACTED]. The statutory merger qualified as an I.R.C. § 332 liquidation. Pursuant to the agreement of liquidation and merger, the statutory merger was to be effective on the date a

certificate of merger was filed with the Oklahoma Secretary of State. On [REDACTED], [REDACTED] and [REDACTED] filed a certificate of ownership, liquidation and merger with the Oklahoma Secretary of State. By operation of Oklahoma law, [REDACTED] received all the [REDACTED] property and assumed all [REDACTED] liabilities upon the merger's effective date.

In [REDACTED] and [REDACTED], [REDACTED] began receiving inquiries concerning some of the corporate assets. [REDACTED] sold off approximately \$[REDACTED] of [REDACTED] equipment and [REDACTED] properties to third parties in [REDACTED]. In [REDACTED], [REDACTED] sold most of its remaining operating assets for approximately \$[REDACTED]. [REDACTED] is now in the process of winding-up its affairs.

b. Analysis

I.R.C. § 108 and I.R.C. § 61(a)(12) govern the taxation of income from discharge of indebtedness. In this case, discharge of indebtedness income could have occurred at two different times during the [REDACTED] taxable year. Firstly, discharge of indebtedness income could potentially have occurred when [REDACTED] acquired the [REDACTED] stock in [REDACTED]. Alternatively, discharge of indebtedness income could have occurred when [REDACTED] was liquidated and merged into [REDACTED]. We have discussed each scenario below.

I.R.C. § 108(e)(4) and the implementing regulations set forth instances where the acquisition of indebtedness by a person related to the debtor may generate discharge of indebtedness income. Treas. Reg. § 1.108-2 describes two types of acquisitions of indebtedness by a related party, direct and indirect acquisitions, which are subject to I.R.C. § 108(e)(4). An acquisition is a direct acquisition if a person related to the debtor (or a person who becomes related to the debtor on the date the indebtedness is acquired) acquires the indebtedness from a person who is not related to the debtor. Treas. Reg. § 1.108-2(b). An indirect acquisition is a transaction in which a holder of outstanding indebtedness becomes related to the debtor, if the holder acquired the indebtedness in anticipation of becoming related to the debtor. Treas. Reg. § 1.108-2(c)(1). All facts and circumstances are considered in determining if indebtedness was acquired by a holder in anticipation of becoming related to a debtor. Treas. Reg. § 1.108-2(c)(2). However, if the holder acquired the debt less than 6 months before becoming related to the debtor, the holder of the debt is treated as having acquired the debt in anticipation of becoming related to the debtor. Treas. Reg. § 1.108-2(c)(3).

Here, neither a direct nor indirect acquisition occurred. No person related to [REDACTED] (or who became related to [REDACTED] on the date the debts were acquired) acquired the debt from an unrelated party. [REDACTED] always maintained ownership of the debts until the [REDACTED] liquidation. Thus, there was no acquisition of the debt by a related party from an unrelated party.

Nor did an indirect acquisition occur. As required by the regulations, a transaction did occur in which the holder of the indebtedness became related to the debtor. This was [REDACTED] acquisition of the [REDACTED] stock. But, the facts fail to show [REDACTED] acquired the debts in anticipation of becoming related to [REDACTED]. To the contrary, the [REDACTED] debts arose more than 6 months prior to the [REDACTED] stock sale and originated from [REDACTED]'s desire to leave the [REDACTED] business. The government could not show [REDACTED] intended to become related at the time of the [REDACTED] asset sale to [REDACTED]. Consequently, there was no indirect acquisition of the [REDACTED] debt in [REDACTED] under Treas. Reg. § 1.108-2(c)(1) and no discharge of indebtedness income in [REDACTED] upon [REDACTED] acquisition of the [REDACTED] stock.

Discharge of indebtedness income may also have occurred when [REDACTED] was liquidated and merged into [REDACTED]. However, Rev. Rul. 74-54, 1974-1 C.B. 76 presents a significant impediment to determining discharge of indebtedness income at that time. In Rev. Rul. 74-54, the government accepted the Board of Tax Appeal's analysis of a similar situation in Estate of Gilmore v. Commissioner, 40 B.T.A. 945 (1939), acq. 1940-1 C.B. 2. The ruling applied that analysis to an I.R.C. § 332 liquidation.

In Gilmore, the principal shareholder of a corporation died. At his death, the shareholder owed money to the corporation. The shareholder's estate caused the corporation to be liquidated. The government contended that discharge of indebtedness income was realized upon liquidation of the corporation. The Board of Tax Appeals rejected the government's position. The Board found that there was no forgiveness of indebtedness, since the indebtedness was treated as a corporate asset and the indebtedness was distributed with the other corporate assets in the liquidation. The Board pointed out that the value of the indebtedness had been reported by the Gilmore Estate and other shareholders when reflecting their respective gain from the corporate liquidation.

Rev. Rul. 74-54 took the holding of Gilmore and applied it to a non-taxable liquidation under I.R.C. § 332. The ruling found that no discharge of indebtedness income occurred on cancellation of a parent corporation's note in a subsidiary's I.R.C. § 332 liquidation. It is very difficult to distinguish this ruling from the [REDACTED] liquidation transaction.

The government might, however, argue that an approach similar to Rev. Rul 93-7, 1993-1 C.B. 125, involving partnership debt, could be applied here. In Rev. Rul. 93-7, the government determined that discharge of indebtedness income occurred when indebtedness of a partner was distributed to the partner and thereby extinguished. Like I.R.C. § 332 and I.R.C. § 334 in the case of parent/subsidiary liquidations, I.R.C. § 731 and I.R.C. § 732 provide for the deferral of gain or loss on partnership distributions and for carryover basis rules to preserve the later recognition of gain or loss from the distributed assets.

In Rev. Rul. 93-7, the government determined that deferred recognition of gain or loss under I.R.C. §§ 731, 732 was inconsistent with the distribution of a partner's debt by the partnership. In that situation, the debt is immediately extinguished and there is no mechanism for preserving the gain or loss inherent in the distributed debt instrument.

In light of that, Rev. Rul. 93-7 found that a partner would recognize any gain or loss from the distribution of his or her debt at the time of the distribution. The recognized gain or loss is determined by comparing the value of the indebtedness to the carryover basis determined under I.R.C. § 732. Rev. Rul. 93-8 also determined that in these circumstances discharge of indebtedness income would be recognized to the extent the issue price of the debt exceeds the fair market value of the indebtedness.

Applying these principles to the [REDACTED] transaction, the government would first have to compare the fair market value of the [REDACTED] debt purchased from [REDACTED], presumably \$[REDACTED], with [REDACTED]'s basis in the debt. [REDACTED] would also recognize discharge of indebtedness income by the amount the issue price of the debt exceeds the debt's fair market value.

This position has very significant litigation hazards. The position is seemingly at odds with Rev. Rul. 74-54. In view of this, the government will have very great difficulty applying the principles set forth in Rev. Rul. 93-7 to subsidiary/parent liquidations like the [REDACTED] situation.

As another alternative here, the government could take the position that the basis of the assets purchased from [REDACTED] in [REDACTED] should be reduced on acquisition of the [REDACTED] stock. This analysis is similar to what occurs from a purchase price reduction of assets. By purchasing Indrex, the only asset of which was [REDACTED] debt, [REDACTED] was in effect obtaining a partial purchase price reduction for the [REDACTED] properties purchased in [REDACTED]. This purchase price reduction analysis would lower the basis of the assets purchased in [REDACTED] to the extent the reduction is attributable to the original acquisition debt. See Rev. Rul. 92-99, 1992-2 C.B. 35, 36 (reflecting the impact on asset basis of I.R.C. § 108(e)(5) purchase price reduction).

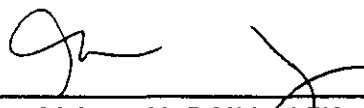
This alternative approach also has inherent litigation hazards. The government would be looking at the substance of the [REDACTED] stock acquisition as a purchase price reduction. The government would be ignoring the fact that the form of the transaction, a stock purchase, would not on its face qualify as an I.R.C. § 108(e)(5) purchase price reduction or a common law purchase price reduction. But, there is merit to taking a substance over form approach here, since: (a) there was little time between the stock acquisition and the liquidating merger; (b) the liquidating merger seems to have been anticipated and when [REDACTED] acquired the [REDACTED] stock; and (c) the closing memorandum for the [REDACTED] stock sale describes the [REDACTED] stock acquisition as "in effect liquidating and settling [REDACTED] indirect debt to [REDACTED]." There does not seem to have been any intention on [REDACTED] part to continue [REDACTED] as an on-going business entity or to use the [REDACTED] assets as part of its on-going business.

If the government takes this alternative approach, the basis reduction to [REDACTED] assets would not include the total difference between the \$[REDACTED] stock price and [REDACTED] outstanding debts to [REDACTED] in [REDACTED]. Of the total [REDACTED] debt outstanding in [REDACTED], \$[REDACTED] was attributable to a revolving credit loan which was not part of the [REDACTED] asset purchase debt. A portion of the debt reduction caused by the [REDACTED] stock acquisition would have to be attributed to the \$[REDACTED] revolving credit loan. In addition, the outstanding balance on the debenture included accrued, but unpaid interest. The accrued, but unpaid interest would not have been included in [REDACTED] basis in the assets acquired in [REDACTED]. Only the original \$[REDACTED] principal balance on the debenture would have been included in the acquired properties' bases. Only the debt reduction attributable to that original principal balance should be taken into account when reducing the basis of [REDACTED] assets.

Please contact Glenn McLoughlin at (405) 297-4803 if you have any questions.

MICHAEL J. O'BRIEN
District Counsel

By:



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cc: ARC (LC), Midstates Region
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